

Internal Revenue Service

Number: **200651012**

Release Date: 12/22/2006

Index Number: 141.00-00, 141.07-00

Department of the Treasury

Washington, DC 20224

Third Party Communication: None

Date of Communication: Not Applicable

Person To Contact:

, ID No.

Telephone Number:

Refer Reply To:

CC:TEGE:EOEG:TEB

PLR-125767-06

Date:

September 12, 2006

LEGEND:

University =

State =

Manager =

Authority =

Agreement A =

Agreement B =

Bonds =

Dormitory =

College =

Date 1 =

Dear

This responds to the request by Authority and University for a ruling that Manager's use of the Dormitory does not constitute private business use of the Dormitory under § 141(b) of the Internal Revenue Code.

Facts and Representations

You make the following factual representations. University is an exempt organization under § 501(c)(3) that operates as a professional art college in State.

On Date 1 University formed Manager as a wholly-owned and wholly-controlled subsidiary of University. Manager is a taxable corporation that provides management, administrative, and operational services to University. Manager is responsible for student recruitment, financial management, management of information technology services, student housing and health, and oversight of third party vendors.

The relationship between University and Manager is defined solely by two agreements, Agreement A and Agreement B, neither of which is terminable or amendable except by University.

University is the sole shareholder of Manager and appoints all of the members of Manager's board of directors. University has the power to approve: (1) amendments to Manager's certificate of incorporation and bylaws; (2) Manager's capital budgets, incurrence of long-term debt, and operating budgets; (3) Manager's strategic plans, risk-management policies, and human resource and benefit policies; and (4) Manager's merger, consolidation, dissolution, or sale or transfer of assets other than in the ordinary course of business.

University is the lessor of Dormitory, a student residence hall located on one of University's campuses. Dormitory is owned by College, also an exempt organization under § 501(c)(3). The cost of constructing and equipping Dormitory was financed with a portion of the proceeds of the Bonds, which were issued by Authority. Dormitory will be used and operated exclusively as a dormitory residence hall for students of University. Leasing and operation of a dormitory residence hall for students is a related trade or business of University.

University and Manager will enter into an agreement (the "Contract") for Manager to manage Dormitory for University. The term of the Contract is 15 years, which is less

than 80 percent of the reasonably expected useful life of Dormitory. Manager's sole compensation under the Contract is a fixed dollar fee payable annually for each year of the term of the Contract. The fee will be adjusted each year to reflect changes in the Consumer Price Index. You represent that the fee will provide reasonable compensation for services rendered, and that no portion of the fee will be based, in whole or in part, on a share of net profits from the operation of Dormitory. The Contract will also provide that University will reimburse Manager for actual and direct expenses paid by Manager to unrelated third parties. The Contract is terminable by University on 90 days written notice, without penalty or cause, at the end of each year of the Contract term. The Contract will automatically renew for one year periods absent cancellation by either party upon 90 days written notice.

Manager's use of Dormitory will consist exclusively of managing Dormitory as a dormitory residence hall for students of University. Manager will not conduct any other operations at Dormitory.

Law and Analysis

Under § 103(a), gross income does not include interest on any state or local bond. Section 103(b) provides, however, that § 103(a) shall not apply to any private activity bond which is not a qualified bond (within the meaning of § 141).

Section 141(a) provides that the term "private activity bond" means any bond issued as part of an issue which (1) meets the private business use test of § 141(b)(1) and the private security or payment test of § 141(b)(2), or (2) meets the private loan financing test of § 141(c). Section 141(b)(1) provides, in general, that an issue meets the private business use test if more than 10 percent of the proceeds of the issue are to be used for any private business use.

Section 141(b)(2) provides, in general, that an issue meets the private security or payment test if the payment of the principal of, or the interest on, more than 10 percent of the proceeds of the issue is (under the terms of the issue or any underlying arrangement) directly or indirectly (A) secured by any interest in property used or to be used for any private business use, or payments in respect of such property, or (B) to be derived from payments (whether or not to the issuer) in respect of property, or borrowed money, used or to be used for a private business use.

Section 141(b)(6) provides that the term "private business use" for purposes of § 141(b), means use (directly or indirectly) in a trade or business carried on by any person other than a governmental unit. For this purpose, any activity carried on by a person other than a natural person is treated as a trade or business.

Section 141(e) provides that the term "qualified bond" includes any private activity bond if such bond is a qualified 501(c)(3) bond and meets other specified requirements.

Section 145(a) provides that a “qualified 501(c)(3) bond” means any private activity bond issued as part of an issue if (1) all property which is to be provided by the net proceeds of the issue is to be owned by a 501(c)(3) organization or a governmental unit, and (2) such bonds would not be a private activity bond if –

(A) 501(c)(3) organizations were treated as governmental units with respect to their activities which do not constitute unrelated trades or businesses, determined by applying § 513(a), and (B) paragraphs (1) and (2) of § 141(b) were applied by substituting “5 percent” for “10 percent” each place it appears and by substituting “net proceeds” for “proceeds” each place it appears.

Section 1.145-2(a) of the Income Tax Regulations provides generally that §§ 1.141-0 through 1.141-15 apply to § 145(a). Section 1.145-2(b) provides, in part, that in applying §§ 1.141-0 through 1.141-15 to § 145(a), (1) references to governmental persons include 501(c)(3) organizations with respect to their activities that do not constitute unrelated trades or businesses under § 513(a); and (2) references to “10 percent” and “proceeds” in the context of the private business use test and the private security or payment test mean “5 percent” and “net proceeds”.

Section 1.141-3(b)(4)(i) provides that, except as provided in § 141-3(d), a management contract with respect to financed property may result in private business use of that property, based on all of the facts and circumstances. A management contract generally results in private business use of that property if the contract provides for compensation for services rendered with compensation based, in whole or in part, on a share of net profits from the operation of the facility. Section 1.141-3(b)(4)(ii) defines a management contract as a management, service, or incentive payment contract between a governmental person and a service provider under which the service provider provides services involving all, a portion of, or any function of, a facility.

Revenue Procedure 97-13, 1993-1 C.B. 507, provides conditions under which a management contract does not result in private business use under § 141(b). It also applies to determinations of whether a management contract causes the test provided in § 145(a)(2)(B) to be met for qualified 501(c)(3) bonds. Section 3.07 of Rev. Proc. 97-13 provides that a “qualified user” means any state or local governmental unit as defined in § 1.103-1 or any instrumentality thereof, and any § 501(c)(3) organization if the financed property is not used in an unrelated trade or business under § 513(a). Under § 5.01 of Rev. Proc. 97-13, if the requirements of § 5 are satisfied, the management contract does not itself result in private business use. Under § 5.02(1) of Rev. Proc. 97-13, the management contract must provide for reasonable compensation for services rendered with no compensation based, in whole or in part, on a share of net profits from the operation of the facility. Reimbursement of the service provider for actual and direct expenses paid by the service provider to unrelated parties is not by itself treated as compensation.

Section 5.03 of Rev. Proc. 97-13 sets forth six specific arrangements that satisfy the requirements of § 5. Under § 5.03(1), at least 95 percent of the compensation for services for each annual period during the term of the contract must be based on a periodic fixed fee. Section 5.03(1) further provides that the term of the contract, including all renewal options, must not exceed the lesser of 80 percent of the reasonably expected useful life of the financed property and 15 years.

Section 3.05 of Rev. Proc. 97-13 provides that a “periodic fixed fee” means a stated dollar amount for services rendered for a specified period of time. For example, a stated dollar amount per month is a periodic fixed fee. The stated dollar amount may automatically increase according to a specified, objective, external standard that is not linked to the output or efficiency of a facility. For example, the Consumer Price index and similar external indices that track increases in prices in an area or increases in revenues or costs in an industry are objective external standards.

Section 3.08 of Rev. Proc. 97-13 provides that a “renewal option” means a provision under which the service provider has a legally enforceable right to renew the contract. Thus, for example, a provision under which a contract is automatically renewed for one-year periods absent cancellation by either party is not a renewal option (even if it is expected to be renewed).

Section 5.04(1) of Rev. Proc. 97-13 generally provides that a service provider must not have any role or relationship with the qualified user that, in effect, substantially limits the qualified user’s ability to exercise its rights, including cancellation rights, under the contract, based on all the facts and circumstances. A safe harbor for this provision is described in § 5.04(2). However, University and Manager are related parties and do not meet the safe harbor.

We conclude that under Rev. Proc. 97-13, the Contract does not result in private business use of Dormitory by Manager. Manager’s compensation under the Contract is reasonable compensation for services rendered, with no portion of the compensation based, in whole or in part, on a share of net profits from the operation of the Dormitory. University will only reimburse Manager for actual and direct expenses paid by Manager to unrelated third parties. All of the compensation to Manager under the Contract satisfies the definition of a periodic fixed fee because it is a stated dollar amount and is adjusted only by a specified, objective, external standard.

The term of the Contract will not exceed the lesser of 80 percent of the reasonably expected useful life of Dormitory and 15 years. Although the Contract will automatically renew for one year periods, it does not contain a renewal option within the meaning of § 3.08 of Rev. Proc. 97-13, since it is cancellable by either party upon 90 days written notice.

Based on the facts and circumstances presented, Manager does not have any role or relationship with University that substantially limits University's ability to exercise its rights, including cancellation rights, under the Contract. Agreement A and Agreement B constitute the entire relationship between University and Manager, and the two agreements cannot be terminated or amended except by University. University is the sole shareholder of Manager and controls Manager through Manager's board of directors. University also has the power to approve: (1) amendments to Manager's certificate of incorporation and bylaws; (2) Manager's capital budgets, incurrence of long-term debt, and operating budgets; (3) Manager's strategic plans, risk-management policies, and human resource and benefit policies; and (4) Manager's merger, consolidation, dissolution, or sale or transfer of assets other than in the ordinary course of business. Further, University may terminate the Contract annually without cause upon 90 days written notice.

Conclusion

Based on the facts and circumstances represented, we conclude that the Contract will not result in private business use of Dormitory under § 141(b).

Except as expressly provided herein, no opinion is expressed or implied concerning the tax consequences of any transaction or item discussed or referenced in this letter.

This ruling is directed only to the taxpayer who requested it. Section 6110(k)(3) provides that it may not be used or cited as precedent.

In accordance with Powers of Attorney on file with this office, copies of this letter are being sent to the authorized representatives of Authority and University.

The ruling contained in this letter is based upon information and representations submitted by Authority and accompanied by a penalty of perjury statement executed by an appropriate party. While this office has not verified any of the materials submitted in support of the request for a ruling, it is subject to verification upon examination.

Sincerely,

Assistant Chief Counsel
(Exempt Organizations/Employment Taxes/
Government Entities)

By: Timothy L. Jones
Senior Counsel
Tax Exempt Bond Branch